

# GENERAL AGREEMENT ON TARIFFS AND TRADE

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## INTERNATIONAL TRADE IN AGRICULTURE

### Communication from Australia

The following communication dated 30 September 1985 has been received from the Delegation of Australia with the request that it be circulated to contracting parties.

The Government of Australia has decided to circulate for the information of contracting parties an independent study entitled, "Agricultural Policies in the European Community - Their Origins, Nature and Effects on Production and Trade".

The study has been prepared by the Australian Bureau of Agricultural Economics. The Bureau is an independent economic research agency located in the Department of Primary Industry. It is not subject to direction as to the research methods employed or conclusions reached. It disseminates its findings widely through published reports.

The study is of direct relevance to on-going and future work in the GATT, in particular:

- A. The Decision of the CONTRACTING PARTIES, recorded in the 1982 Ministerial Declaration, to examine:
  - . trade measures affecting market access and supplies, with a view to achieving greater liberalization in the trade of agricultural products, with respect to tariffs and non-tariff measures, on a basis of overall reciprocity and mutual advantage under the General Agreement; and
  - . the operation of the General Agreement as regards subsidies affecting agriculture, especially export subsidies, with a view to examining its effectiveness, in the light of actual experience, in promoting the objectives of the General Agreement and avoiding subsidization seriously prejudicial to the trade or interests of contracting parties. Other forms of export assistance will be included in this examination; and
- B. The work of the Committee on Trade in Agriculture and other relevant bodies of the GATT to fulfil this mandate.

The contents of the study also underline the essentiality of high priority being given to negotiating measures to liberalize agricultural trade in the forthcoming Multilateral Trade Round. This objective is shared by the majority of contracting parties and circulation of the study is designed to assist them and others to realise this objective.

The primary conclusions of the study are that:

- (i) Since the implementation of the Common Agricultural Policy there has been a massive turnaround in the agricultural trading position of the European Community. It has changed from being one of the world's largest importers of temperate zone agricultural products to now being the world's second largest exporter.
- (ii) This change in trading position has been at a high cost to agricultural producing nations as a whole. It is estimated that EC agricultural policies, which have stimulated production and subsidized exports, have depressed world prices of major temperate agricultural products by, on average, some 16 per cent. This lowering of prices has had adverse effects on other agricultural exporting nations, particularly countries dependent on agricultural exports.
- (iii) In the case of Australia, it has been estimated that the CAP has cost the Australian economy almost \$1 billion per annum over the past few years.
- (iv) The change in trading position of the EC has also been achieved at a high cost to the European Communities. It is estimated that, over the past decade, about 60 per cent of the value added by agriculture in the European Community has come from consumers and taxpayers by way of transfers and subsidies. These transfers and subsidies have amounted to between 60 billion and 70 billion ECU a year in 1984 values which is about four times EC budget expenditure on agriculture.

The Australian Government agrees with the conclusions of the report. It should be noted however that the report is not an official report of the Australian Government. The analyses and contents are solely the responsibility of the Bureau of Agricultural Economics.

The Australian Government is aware that it is not the agricultural policies of the European Communities alone which distort international trade in agriculture. But the agricultural policies of the European Communities are regarded by the Australian Government as the primary problem for all agricultural trading nations whether developed or developing.

One copy of the full study by the Bureau of Agricultural Economics on "Agricultural Policies in the European Community" has been distributed to each contracting party.<sup>1</sup>

A copy of the summary of the study (English only) is attached to this document.

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<sup>1</sup>Additional copies of the study may be obtained from:

The Australian Government Publishing Service  
P.O. Box 84

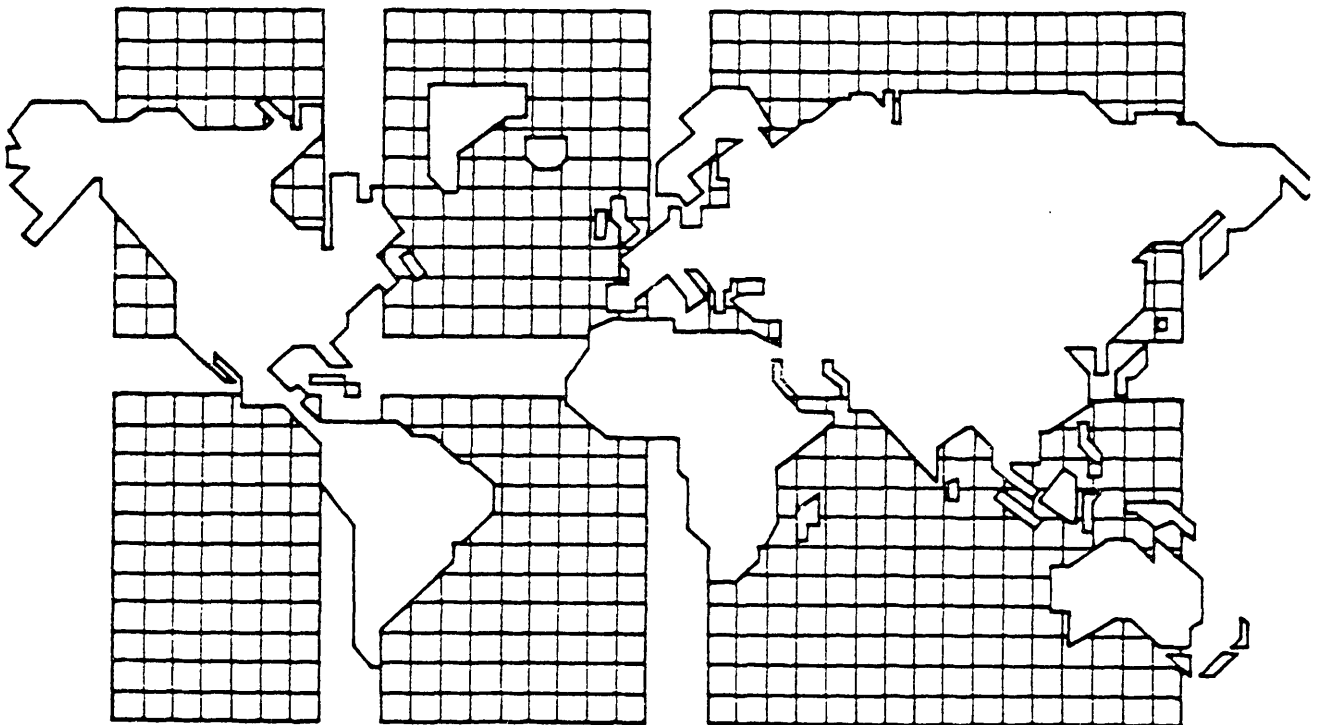
Canberra ACT 2600

# **Agricultural policies in the European Community**

**Their origins, nature and effects  
on production and trade**

**Summary**

**Policy monograph no. 2**



**Bureau of Agricultural Economics**

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## Foreword

The formation of the European Community was a significant political and economic event. While many political benefits within Europe may be attributed to the establishment of the Community, certain aspects of EC policies have had adverse consequences, both for the Community itself and for other countries. This is especially true of aspects of the Common Agricultural Policy, which is often considered to be the Community's most concrete achievement.

The CAP and associated mechanisms were based on a perceived need to insulate the agricultural sectors of EC countries from the effects of international competition. By doing this mainly through substantial and open-ended price support, the Community has been transformed from a large net importer to a very large net exporter of many major agricultural products.

Agricultural protection in the Community has resulted in high costs to consumers and taxpayers, while the generation of surpluses has depressed world prices and caused severe financial management problems. At the same time it has imposed substantial costs on traditional exporters of temperate zone agricultural products — such as Australia.

This study is based on the knowledge that a fuller understanding of the CAP — its role within the European Community, the institutional arrangements that are part of it, the various costs to the Community's economy (including the adverse consequences for traditional labour-intensive manufacturing industries), and the costs to world agriculture and the developing economies — is a prerequisite to any rational policy choices by governments, both in the Community and elsewhere.

Clearly, the European Community could achieve its desired objectives by pursuing alternative policies which would be both less costly to itself and less damaging to the agricultural industries and economies of other countries.

It is hoped that this study will stimulate debate within and outside the European Community on ways in which such policies might be implemented.

ANDY STOECKEL

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August 1985

## Acknowledgments

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Ivan Roberts was the project director and is the principal author of the report. Assistance in co-ordinating the project was provided by Graeme Tie, who is the author of chapter 8 and joint author of chapters 2, 10, 11 and 14, and Neil Andrews, who is joint author of chapters 7 and 17. Other joint authors include Paul Flint (chapter 4), David Barrett (chapter 12), John Cameron (chapters 13 and 14), Donald Muir and Gordon Duffus (chapter 15) and Andy Stoeckel (chapter 18). Other Bureau staff provided assistance with the research at various stages, particularly Geof Watts on quantitative aspects.

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The editing and preparation of a report of this size for publication, against tight deadlines, is an immense task and one accomplished admirably by Judith Fenelon. The book design, including the cover, and the preparation of all artwork was undertaken by Claudia Tregonning. Word processing was carried out by Colleen McCoy and Kay Smith and the typesetting by Canberra Publishing and Printing Co.

The collection of information for the study required extensive travel by Ivan Roberts, who is grateful for the assistance provided by the following individuals and organisations:

### **Federal Republic of Germany**

German Foreign Traders' Association  
German Consumers' Organisation  
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University of Bonn  
German Farmers' Federation  
German Meat Traders' Association  
Chamber of Agriculture, Hannover  
Department of Agricultural Economics, University of Göttingen  
Institute for Agricultural Marketing, Braunschweig  
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Australian Office of the Minister Commercial, Bonn

### **The Netherlands**

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Cornelder's Shipping Company  
Industrial Board of Agriculture  
Commodity Board — Dairy

Dronrijp cheese factory  
Central Sugar Company  
Rabobank  
Commodity Board — Arable Products  
Commodity Board — Cattle and Meat  
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SEDES (Society for Research into Economic and Social Development)  
Australian Office of the Minister Commercial, Paris

**United Kingdom**

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**Australia**

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Department of Trade, Canberra

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## Summary

Since the implementation of the Common Agricultural Policy, there has been a massive turnaround in the agricultural trading position of the European Community. It has changed from being one of the world's largest importers of temperate zone agricultural products to now being the world's second largest exporter.

**Major effects of the CAP**

This change in trading position has been achieved at high cost to both the Community and agricultural producing nations as a whole. It is estimated that, over the past decade, about 60 per cent of the value added by agriculture in the European Community has come from consumers and taxpayers by way of transfers and subsidies. These have amounted to between 60 000m ECU and 70 000m ECU a year in 1984 values. It is further estimated that EC agricultural policies, which have stimulated production and subsidised exports, have depressed world prices of major temperate agricultural products by, on average, some 16 per cent. This lowering of world prices has had adverse effects on other agricultural exporting nations, particularly countries dependent on agricultural exports. The cost to the Australian economy, for example, has been estimated at almost \$A1000m a year in recent years. The effects of EC policies on world agricultural trade are a consequence of the European Community pursuing domestic policy objectives with a system of largely open-ended price support. It is concluded that EC policy objectives could be achieved at substantially lower cost, both to the Community and to other countries.

**EC trading position achieved at a cost**

In this study, the nature, the origins and the effects of the CAP on EC agricultural production and trade are examined. The importance of the CAP for other agricultural exporting nations like Australia and for different commodities is traced, and an assessment of policy alternatives and the prospects for reform of the CAP is made.

**Scope of study**

### The nature of the CAP

The CAP is a system of policies developed to achieve the objectives of farm income support, promotion of technical efficiency and efficiency of resource use, price stabilisation and food security, as laid down under the Treaty of Rome in 1957. That Treaty established the European Economic Community, with agriculture singled out for special attention. Agriculture was given prominence because of widespread rural welfare problems, the relative backwardness of agricultural production methods and systems in many areas and a desire in the Community for greater security of food supplies. The last-mentioned factor has probably been overstressed, as the Community had high self-sufficiency rates for most temperate agricultural products even in the mid-1950s.

**Treatment of agriculture under the Treaty of Rome**

**CAP formation led to increased protection**

The system adopted for the six initial EC members was consistent with the highly protective agricultural policies that had applied in the individual members. Those policies were largely a legacy of the depression of the 1930s and highly regulative war-time arrangements, although most members had a history of agricultural protectionism even before the beginning of the twentieth century. In fact, the formation of the Common Agricultural Policy during the 1960s resulted in an increase in agricultural protection against goods from non-member countries. The CAP has since had a profound effect on the regional orientation of world agricultural production and trade.

**CAP principles**

The three fundamental principles or 'pillars' on which the CAP has been based are free trade within the Community, preference for member countries and joint financial responsibility.

**EC decision making and policy implementation**

Generally, support under the CAP has been provided by maintaining prices well above world market levels (on unlimited volumes for most products) with insulation from outside competition. Levels of most support prices and other policy parameters are determined annually through negotiations between the EC members. Those negotiations involve the interaction of many consultative, advisory, proposing and, finally, decision making institutions. Of particular importance are the Commission, which makes proposals, and the Council of Ministers (agriculture), which makes decisions. The European Parliament, which is responsible for passing the budget, also plays a part. Responsibility for implementing the decisions is in the hands of the Commission, while the direct application of the policy machinery in each EC member country is carried out by national intervention boards and agencies.

**Support mechanisms for the major products**

Different support regimes have been developed for the various commodities. For the major agricultural items, including grains, milk and milk products, and beef and veal, the support systems involve a combination of variable levies on imports, intervention agency purchasing and variable subsidies (restitutions) on exports. For sugar, the same mechanisms are used, but the quantities receiving support are subject to limitations. Sheep meat is supported through a combination of intervention purchasing, deficiency payments and voluntary restraints on imports. Oilseeds are supported largely by deficiency payments. Fresh fruit and vegetables are supported through import duties, market withdrawal when prices fall below specified levels, and export restitutions. Wine is supported mainly through market withdrawal for distillation when prices fall below specified levels and storage aids. For dried vine fruit, the support mechanisms are minimum import prices, minimum producer prices, processing aids and export restitutions. Canning fruit is supported through minimum grower prices, production aids and import tariffs.

**Forms of support and dependence on the budget**

While all of the forms of support used effectively insulate internal prices from world market forces, the nature of the different regimes is important for budgetary reasons. Under variable levy – intervention – export restitution arrangements, much of the support is provided by maintaining domestic prices above world price levels. It is only when



production exceeds domestic consumption that budgetary funds are required in large amounts to support items covered by these arrangements. However, the regimes based on deficiency payments and production aids rely more for their support on funds from the Community budget.

The availability of funds for the Community budget is important in influencing the levels of support for agriculture, despite the fact that EC budgetary support constitutes only about a quarter of total support for the Community's agricultural sector. Agricultural expenditure constitutes some two-thirds of total Community spending, so limits on the overall availability of funds could be expected to restrain the pricing decisions and the associated degree of agricultural support. Funds belonging to the Community by right, termed 'own resources', include import duties, agricultural levies (variable levies on agricultural imports and special levies on a part of sugar production) and up to 1.0 per cent of the Community's value-added tax base. A decision has been made to increase the value-added tax limit to 1.4 per cent from 1 January 1986, the date that Spain and Portugal join the Community.

**Availability of funds influences agricultural support**

### **Application of the CAP and its effects**

Since the CAP became fully operational in the late 1960s, EC agricultural production has risen consistently by almost 2 per cent a year. However, consumption levels in the Community have been rising by only about 0.5 per cent a year. In recent years the Community has changed from being a net importer of several major commodities, including sugar, cereals and beef and veal, to being a substantial net exporter. At the same time, exports of dairy products have risen to extremely high levels. This has occurred despite the expansion of the Community in 1973 to incorporate the United Kingdom, Ireland and Denmark. (The United Kingdom was, at that time, a very large net importer of agricultural products.)

**EC production rising faster than consumption**

Since 1973, the prices received by EC farmers for agricultural products, which are determined through the EC institutional pricing arrangements and market management, have declined relative to farm input prices by, on average, about 1.5 per cent a year. However, the internal market prices have generally remained well above world prices, and the price differentials have been maintained. There have, of course, been deviations, such as with sugar in the mid-1970s and wheat in 1984-85.

**EC market prices generally above world prices**

The price policy has been very successful in cushioning EC producers against the wide variations that have characterised international agricultural prices since the early 1970s. Consequently, the stabilisation objective could be said to have been achieved. But because world prices have varied, the levels of assistance accorded EC agriculture have fluctuated considerably over time. They declined markedly in 1974 and 1975, when world prices were relatively high for most agricultural products. However, support levels then rose sharply to peak in 1978. They subsequently subsided somewhat in real terms, initially as a result of a slowing in support price increases from 1979 to

**Assistance has varied over time**

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<b>Components of EC agricultural support</b>	<p>1981 (the prudent price policy) and then as a result of increased world demand and prices for dairy products in 1981 and 1982. With a return to low world prices for dairy products, a fairly large increase in support prices in 1982 and the emergence of large and increasing EC stocks for a range of commodities in 1983 and 1984, support levels have climbed once more.</p> <p>There are three principal components in EC agricultural support — transfers from consumers through internal prices that are maintained above world prices; EC budgetary support through export restitutions, storage and other aids; and national governments' budgetary support for research and advisory services, infrastructure and farm structural development and through taxation and some input cost concessions. In addition, there is some support through the Guidance Section of the European Agricultural Guidance and Guarantee Fund to help improve the structure of farming, largely in disadvantaged areas.</p>
<b>Relative importance of support</b>	<p>Consumer transfers constitute the largest element of support, usually accounting for between one-half and two-thirds of total support. Their relative importance peaked around 1977-78. However, support expenditure from the EC budget has been expanding rapidly since the mid-1970s and is now estimated to account for about a quarter of total agricultural support from all sources. The increase in EC budgetary expenditure has been a consequence of rising subsidised exports in the latter part of the 1970s, rapidly increasing aids for storage in the 1980s as stocks have expanded greatly, extension of Community support to include, notably, sheep meat, and increased aid for items like oilseeds, which receive most of their support through the budget. Large increases have also occurred in budgetary outlays on wine, principally for distillation of surpluses, and fruit and vegetables, mainly for market withdrawals and processing aids.</p>
<b>Total transfers to agriculture</b>	<p>Since 1976, total transfers from all sources to EC agriculture have varied between 57 000m ECU and 73 000m ECU a year in 1984 values (between 50 000m ECU and 64 000m ECU in 1982 values). Over the past decade, such transfers have been equivalent to approximately 60 per cent of the value added by the sector. The overall cost of support for EC agriculture is estimated to have been around 980 ECU per non-farm family of four a year in 1984 values (860 ECU in 1982 values). Although there have been wide variations from year to year in real levels of EC agricultural support, the long-term trend has been rising gradually.</p>
<b>Long-term upward trend in support</b>	<p>The high support levels have contributed markedly to the continuous expansion of EC production and the increasing accumulation of surpluses. The stated 'norm' at which the support prices are intended to be pitched is the efficient family farm. However, this is difficult to define in a region with such wide differences in incomes between countries and such diverse types of agriculture. The distribution of farms by enterprise size is very skewed. In 1975, 24 per cent of farms accounted for over 70 per cent of total production and there has been a trend toward greater concentration. Also, there is a trend toward</p>
<b>Support prices and the efficient family farm</b>	

part-time farming, especially in the Federal Republic of Germany, making it even more difficult to define the kinds of people whose incomes are being supported.

The number of persons employed in EC agriculture has been declining and in 1983 was 7 million (for the EC-9) compared with 17 million in 1960. Since 1973 the rate of decline has fluctuated around 2-3 per cent a year, which is lower than in the 1960s and early 1970s due largely to fewer non-farm employment opportunities. Farm incomes have been stable in real terms since 1973, following a period of marked increase caused partly by the rapid rate of exit and amalgamations of farms.

The wide disparity in incomes between producers with large farms and those with small farms makes the Community's method of supporting farm income very inefficient from a welfare standpoint, as most farmers have small operations and the support given through the price mechanism is in direct proportion to output. The operators of the top 25 per cent of farms, in terms of size, are estimated to receive about 75 per cent of the budgetary support — averaging some 9700 ECU per farm a year. The remaining farmers receive an average of about 1100 ECU per farm a year. Also, it is mainly producers on large farms who are increasing output in response to the pricing decisions.

The EC policy of supporting prices provides incentives for private research and development and high levels of public expenditure by national governments on research and infrastructure in agriculture. Largely as a result of these incentives, there have been rapid gains in productivity. These gains, together with higher levels of investment and variable input use by farmers due to the support prices, have resulted in a fairly steady upward trend in total agricultural output.

The results of analyses in this study indicate that EC agricultural production responds only slightly in the short term (one year) to changes in the prices received for farm output relative to the prices paid for farm inputs. However, the long-term impact of real price changes is substantial as they influence investment levels and subsequent variable input use. The cumulative nature of supply responses to pricing decisions and the low short-term responsiveness of supply to price changes could result in the EC annual determination of prices being inconsistent with restraint in production and exports. Relatively generous pricing decisions may appear not to contribute much to surpluses because of the small immediate response. However, they do, in fact, stimulate production for many years.

## **EC supplies and world markets**

Because EC production and consumption levels are so large relative to world trade in the major temperate agricultural products, relatively small changes in the balance between EC production and consumption have a substantial impact on volumes traded and world prices.

The European Community's protective agricultural policies both depress and destabilise prices on world markets. They depress them

**Farm workforce declining**

**Main beneficiaries of support are the few with large farms**

**Supported prices are incentive for research and development**

**Impact of annual pricing decisions on production**

**Impact of EC production-consumption balance**

**EC policies depress and destabilise world prices**

by increasing production, to some extent restraining domestic consumption, and ensuring that surpluses are internationally competitive by using export subsidies. They destabilise them by insulating the large EC market, thereby preventing it from absorbing part of the variations in world supplies, and by using the world market to absorb variations in EC supplies.

**EC trade changes large relative to world trade growth**

The volume of world trade in agricultural products (excluding intra-EC trade) rose by about one-third between 1972 and 1980, after which it stabilised. For items of major concern to Australia, the change in EC trade, either through a reduction in imports or through a turnaround from being a net importer to being a net exporter, has been very large in relation to the overall growth in world trade. Between the periods 1973-74 and 1981-82, the reduction in EC net imports or the increase in net exports was equivalent to almost the entire growth in world exports of beef and veal, butter and sugar. The changes for both cheese and wheat were equivalent to about half of the growth in world trade in those products. In that same period, the decline in EC net imports of other grains was equivalent to about a third of the growth in world trade in those grains.

**EC policies a large influence on world market**

The Community's agricultural policies have been shown in several studies to have depressed and destabilised world prices more than the protective policies of other countries. World prices for wheat, coarse grains, sugar and ruminant meats are estimated to have been depressed by between 9 per cent and 17 per cent and those for butter by 28 per cent. It should be stressed, however, that the European Community is by no means the only region in the world with policies that can be seen to force world prices down. It should be acknowledged that there is a degree of interaction between the policies of one region and the trade policies of others.

**Restrained world demand contributes to budgetary crisis**

### **EC budget problems and recent reforms**

Costs of agricultural support constitute about two-thirds of EC budgetary expenditure. These costs have risen rapidly since 1980 due to increasing surpluses and restrained overseas demand. Rising storage costs and rapid increases in expenditure on domestic disposal of surpluses (for example, wine distillation and withdrawal of fruit and vegetables from the market) have accounted for much of the increase; but export subsidies have remained substantial. Also, support for 'Mediterranean' products has risen sharply in order to reduce support disparities between these and 'northern' products. These increases, together with limits on own resources and demand for social and welfare programs, have resulted in a Community financial 'crisis'.

**Own resources insufficient recently**

Limits on the funds available to the Community have been important in restraining support price increases for agricultural products. However, in 1982-83, following a relatively brief period of improved world market conditions for dairy products, the main budget expenditure item, a significant catch-up support price increase was granted. Subsequent high production and poor world market conditions

resulted in sharp increases in agricultural budgetary expenditure in 1983 and 1984, and the Community's resources from its normal entitlements were inadequate to cover expenditure commitments. Ingenious manipulation of available funds and emergency measures enabled 1983 and 1984 commitments to be met. The decision made in mid-1984 to extend the Community's own resources by increasing the Community VAT percentage entitlement from 1.0 per cent to 1.4 per cent from 1 January 1986 will take some of the pressure off expenditure from that time. Special non-repayable contributions have been agreed on to meet the budgetary shortfall in 1985. However, the entry of Spain and Portugal to the Community in 1986 will result in a further drain on own resources. Consequently, the own resources 'limit' is likely to continue to restrain agriculture support decisions.

**Measures to enable expenditure commitments to be met**

Faced with problems of financing its agricultural support, the Community has been taking measures to restrain expenditure. Those taken so far have arisen mainly from reviews of the CAP in 1981 and 1983. The principal measures have been the application of the threshold principle, quotas on milk, more stringent intervention arrangements, and proposed disciplines on future total EC expenditure and agricultural expenditure. There has also been wider application of co-responsibility levies, which were first introduced in 1977.

**Measures taken to restrain expenditure**

The threshold principle is designed to prevent budgetary support from being open-ended. It is applied differently for different items. For example, price increases for cereals are discounted if a previously agreed to production threshold is exceeded, while quotas have been placed on milk production, with co-responsibility levies to help finance surplus disposal.

**Threshold principle designed to limit support**

It is not clear whether the threshold arrangement for cereals has resulted in lower prices than would otherwise have applied. Of probably greater significance in the past year has been the day-to-day management of marketing by the Commission. This has allowed internal prices following the huge 1984 wheat harvest to decline markedly. Similarly, large increases in beef stocks necessitated more stringent management of intervention, allowing marked price reductions in 1984-85.

**Market management and lower wheat and beef prices**

The most notable single reform has been the application of quotas and superlevies on milk production for the five years ending in 1988-89. Milk has been the sector of EC agriculture with the largest surpluses and it constitutes about 20 per cent of the value of EC agricultural production. If no resources were diverted from dairying to other activities such as meat and grain production, the quotas would initially reduce EC agricultural production by about 1 per cent and thereafter by 0.4 per cent a year. However, dairying resources will be displaced and a large proportion of those resources are likely to be diverted to alternative agricultural enterprises.

**Milk quotas aimed at limiting production**

Even with the quota reduction, EC milk production will be some 14 per cent above domestic consumption, and the Community will at least maintain its dominant position on world dairy product markets.

**... but world market share will be maintained**

The present huge EC dairy product stocks will be reduced as a result of the quotas and large low-price butter sales to the USSR and, by the end of the quota period, world prices may be higher than the present depressed levels. Although milk quotas seem likely to be retained, if world market conditions were to improve, there would then be pressure for them to be relaxed to allow greater production. There have been indications that a preferred way of compensating dairy farmers for production restraint is to increase prices more than otherwise within quotas.

**Problems with quotas**

The resort to quotas for milk was regarded as a preferred option to reducing prices by 12 per cent, which was regarded as politically not achievable. The quotas have not been negotiable separately from the land of the farms to which they have been allocated, which is likely, initially, to limit the transfer of resources and slow down improvements in industry efficiency. But, there is a strong possibility that in the longer term the diversion of resources to alternative enterprises could lead to increased production and surpluses or increased surpluses of other products (meat and crops), thereby increasing budgetary support costs and at least partly offsetting the direct budgetary cost savings on milk and milk products. In addition, increased surpluses would impose substantial costs on both the EC economy and other exporting countries. These costs might be overcome by applying quotas to many alternative products at the same time. However, the administrative problems and resource allocation costs of such a course would probably be substantial. Also, the economic costs associated with impediments to adjustment could be large, especially if efficient methods of transferring quotas were not developed.

**So far, price restraint insufficient**

Although price increases have been restrained at times in the past, the degree of restraint has been insufficient to slow production growth and surplus generation more than marginally. This was the case in the period of the 'prudent price policy' from 1979 to 1981, when prices received by farmers declined by some 3 per cent a year relative to input prices. At that time, the depressing effects of price restraint on production were offset by the stimulating effects of previous high levels of investment and productivity growth. Then the price catch-up in 1982 would have undone much of the effect of previous price restraint in containing production growth and surplus generation.

**Community resorting more to quotas**

It appears that, through its increasing reliance on quotas as a means of restraining production, the Community is making a judgment that it is politically not possible to maintain the continuous reductions in real prices necessary to contain agricultural surpluses and expenditure.

**Institutional arrangements to restrain expenditure**

The other significant area of recent reform has been the establishment of institutional machinery to tighten discipline on total Community expenditure and on agricultural expenditure in particular. To do this, the Council (finance ministers) has been given a greater role in what was the province of the Council (agriculture ministers) in support determinations. The arrangement may restrain expenditure decisions slightly.

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## Factors promoting reform

Most of the reforms implemented so far appear to have been marginal and consistent with the extent of the threat to the Community's financial viability. They will be a mild restraint on the rate of production growth in agriculture as a whole — but a restraint that could be relaxed somewhat when extra funds become available from the beginning of 1986 and if market conditions were to improve even temporarily.

**Reforms a mild restraint on production growth**

The limits to the Community's funds have provided the motivation for the reforms that have occurred, even though EC budgetary expenditure accounts for only about one-quarter of the total transfers from taxpayers and consumers to agriculture. However, the budgetary constraint does not provide a strong motivation for the kinds of reform necessary to reduce EC exportable surpluses and the economic costs associated with the CAP. This is because, when the pressure on available funds becomes so strong that it can no longer be resisted by the net contributing members, they will agree to increase own resources. That has already happened and the acknowledgment in the Fountainebleau summit decisions in mid-1984 that a further increase in own resources might be required by 1988 is indicative that fundamental changes designed to prevent that from occurring are not envisaged.

**Budgetary problems and pressures for reform**

The budgetary limits are likely to provide the motivation for keeping the reform debate active and to result in sufficient pricing and other support restraint to prevent an unmanageable increase in expenditure to greatly beyond own resources. However, the budgetary limits alone seem unlikely to result in the kind of reforms that will markedly reduce the costs to the EC economy and to other countries as a result of the CAP. Such reforms are likely only if there is acknowledgment of those costs throughout the Community and there is institutional reform which ensures that perceived national interests of EC members who believe that their countries benefit from high agricultural support can be subordinated more to the wider interests of the Community.

**Significant reform requires acknowledgment of total costs**

The CAP is primarily a domestic-oriented policy with substantial international effects. Strategies of other countries to bring about reform of the CAP are subject to many limitations. There are problems in reaching international co-operation agreements with the European Community, as other countries find it difficult to accept that the Community's share of world trade should be that developed by using export subsidies. Also, the favoured EC approach to stabilising international prices (the use of special stocks) is subject to limitations unless other disciplines on production or exports are applied.

**Limitations on international pressure**

The United States is the only country with the economic power to impose high costs on the European Community through a competitive subsidy race, or trade war. Even then the area of conflict would be limited mainly to wheat and wheaten products and coarse grains, as the United States is not a significant exporter of other major EC export items such as dairy products, sugar and beef and veal. Depending on the product, such an approach would or could cost US taxpayers

**Possible US tactic against EC policies**

**Another possible US strategy**

much more than the increase in EC budget costs through the depressing effect on world prices. Other exporting countries, including Australia, Canada and Argentina, would be adversely affected, as would be producers in importing, developing countries, which would have to compete with cheaper imports. It is likely that the EC response to such a US tactic would be to increase its agricultural support.

Another way for the United States to attempt to induce reductions in EC agricultural support would be for it to reduce both its own support prices and the incentives for US farmers to take land out of production. That would make US products more competitive and increase EC support costs in the short term, but the impact in the longer term is less certain.

**Depreciation of US dollar could induce change**

Exchange rate changes appear to have a greater potential to force reforms in EC agricultural support. In particular, if the US dollar were to depreciate markedly relative to EC currencies, it could induce large increases in EC support costs. The Commission estimates that a 10 per cent depreciation of the US dollar relative to the ECU would add between 700m ECU and 1000m ECU to EC budget expenditure a year. In addition, the depressing effect that it would have on world prices would add to EC consumer transfers. The response of the Community to such a development cannot be predicted with any confidence.

Overall, it appears that pressures by other countries to force change in EC agricultural policies will have, at best, a marginal impact. The CAP is essentially an inward looking policy and any fundamental reforms are most likely to be generated internally. However, there is a chance that the Community could come to realise that it would be in its own interests, as well as those of other countries, to enter constructively into negotiations within the General Agreement on Tariffs and Trade to strengthen the rules on subsidies for agriculture.

**Major pressure for reform would come from within the EC**

The main factor that could lead to a reduction in EC agricultural support is the cost that it imposes on non-farm groups in the Community. That cost has recently been highlighted in the debate on the EC budget and budgetary financing. However, the emphasis has been, and still is, largely on only about a quarter of the costs — those associated with the EC budget. To date, consumers have been very accepting of the high levels of supported prices. Also, there appears to have been only a limited appreciation by leaders of manufacturing industries, trade unions and the urban unemployed that their industries and members are bearing the costs of agricultural support. However, a greater appreciation of the costs imposed on them would, over time, bring about pressures for change. A climate of opinion that is conducive to reducing agricultural support is essential if such a reduction is to eventuate.

**Defining the CAP problem**

**Future reform options**

Even with the surpluses generated in recent years, the bulk of EC agricultural production is still sold domestically. The meeting of trade objectives is not a primary purpose of the CAP. Trade policies have



had to be developed to defend or realise the internal policies. The trade difficulties and many of the costs resulting from the CAP are by-products of pursuing domestic objectives by using inefficient policy instruments — primarily open-ended price supports incorporating a high level of protection. These generate surpluses at a substantial cost to the economy.

The price support instrument has been used as a panacea to meet a wide range of inadequately defined and often inconsistent domestic policy objectives. If the objectives were more clearly defined and efforts made to eliminate the inconsistencies, it should, in principle, be possible to design specific policies with appropriate policy instruments to meet each objective at the lowest possible cost. In considering the cost associated with a policy, it is important to account fully for its effect on consumer transfers as well as on the more visible Community budget outlay. Also, the adverse effects of agricultural protection on the profitability of and employment levels in other industries should be recognised.

If a policy objective is to improve the living standards of most farmers in an area such as the European Community, where a small proportion of producers produce most of the output, price support is not very efficient. It increases output by the few producers with large enterprises and gives little support to the large number of producers with small operations. A much more effective and efficient approach would be to reduce support prices markedly, thereby reducing the propensity to produce surpluses which are expensive to the economy, and to use the funds so released to support the incomes of the majority of farmers directly. As those farmers receiving support would be producing a relatively small proportion of total output and the support would not be linked to production, it would have a much smaller stimulatory effect on production than present arrangements. Such a strategy of direct income support has been recently acknowledged as a reform option by the Commission.

If an objective is to achieve self-sufficiency, the optimum approach might be a much greater degree of price restraint than in the past, together with direct income support. A 'second best' approach could be a two-price system, with quota output equal to domestic requirements receiving supported prices and above-quota production receiving world prices. This approach may be appropriate, depending on how the domestic quotas are allocated and on the degree of quota transferability. The way in which quotas are allocated can be very important in influencing whether they are successful in reducing surpluses. If they are allocated primarily to marginal producers, it is likely that they will be relatively ineffective in reducing surpluses, as long as output above domestic requirements receives world prices.

If another objective is to prevent regional unemployment, employment-creation programs, relocation and retraining and adjustment assistance programs could be more effective than general price support arrangements for agricultural products. There is evidence that price support does little to reduce the rate of labour outflow from

**Appropriate instruments for each objective**

**Examples of instruments for objectives**

— income support to improve living standards

— price restraint for self-sufficiency

— programs to prevent regional unemployment

**— prevention of  
food shortages in  
developing  
countries**

agriculture in total, as the direct stimulatory effect of the support on employment is approximately offset by the growth in labour-displacing investment associated with the support.

A sometimes stated objective of the CAP is to prevent periodic severe food shortages in certain developing countries. While the appropriate form of aid depends on the causes of the shortages and on regional circumstances, in general a more appropriate policy than EC price support to increase domestic production could be to provide financial aid so that countries could purchase food to meet the immediate crisis; to improve famine early-warning systems; and to help those countries establish improved food production, handling and distribution facilities. The problem of regional famine today is not one of inadequate world food supplies; it is primarily a lack of purchasing power and inadequate infrastructure and production-incentive systems in the developing countries themselves.

**Effectiveness of EC  
reforms so far**

The main reforms made so far — the introduction of guarantee thresholds, co-responsibility levies and quotas — were intended primarily to ease budget management problems, although they could reduce EC surpluses and their depressing effect on world prices. However, given the incidence of the reforms, their effectiveness in reducing EC surpluses in aggregate is open to question and they may also be relatively ineffective in restraining budget expenditure. For commodities like cereals, for which the threshold system is designed to result in price discounts if past production exceeds the agreed threshold, the price discounts have been insufficient to offset productivity gains. Also, although the quotas on milk and the very high levies on overquota production seem likely to restrain milk production, resources will be diverted into the production of other items, thereby increasing surpluses and support costs for those items, mainly grains and beef. Co-responsibility levies are primarily a revenue raising instrument, which has a relatively small impact on production.

**Real price  
reductions required**

The extent to which real prices might have to be reduced to bring the EC production growth rate into line with domestic consumption growth, thereby preventing further increases in surpluses, is an important policy benchmark. From simulations carried out in this study, it seems that, to prevent further increases in surpluses, the prices received for agricultural products relative to prices paid for inputs would need to be reduced by 5 per cent a year for about four years, after which consistent 4 per cent annual reductions would be required. At these rates of reduction, the gap between EC prices and world market prices would probably close fairly rapidly — depending on exchange rate movements, especially relative to the US dollar.

**Price restraint  
important**

A policy of price restraint is obviously important in the European Community as long as price support remains the principal policy instrument used. It is estimated that, for each additional 1 percentage point that real prices are reduced below the trend rate of reduction since 1973 (about 1.5 per cent a year), the gap between the production and consumption growth rates, which has averaged about 1.5 percentage points, is reduced by 0.4 percentage points.

## Reasons for reform being slow

The reform of agricultural policies in the European Community has been slow for two main reasons. First, there has been a failure or an unwillingness to appreciate the full cost associated with the CAP. Second, there are institutional factors which make it difficult to introduce fundamental changes.

The failure or unwillingness to appreciate the costs associated with agricultural protection is evident from the preoccupation with only the visible budgetary costs, which are but one part of the total cost — a part that is much less important in economic terms than transfers from consumers in the form of higher prices. It is also apparent from the lack of co-ordination by governments to measure and monitor levels of protection for agricultural and other industries so that industrial strategies could be developed.

As well as costs to consumers and taxpayers, the CAP imposes costs on other traded goods sectors. Export subsidies on agricultural products result in an implicit subsidy on the importation of other traded goods, principally manufactured goods. This means that imports of manufactured goods are encouraged and the competitive position of exporters of manufactured goods is eroded. This effect would result in reduced employment in EC manufacturing industries. In addition, many of the scarce resources now devoted to agricultural research and development, because of the high levels of agricultural support, would make a greater contribution to the economy if they were used in activities that were competitive without any or much support.

Institutional factors that appear to have contributed to the slowness of EC agricultural policy reform relate largely to the supranational nature of the Community, the need to reach agreement between countries with vastly different agricultural sectors and policy objectives, and the inertia of large administrative systems. In particular, the arrangements for the pooling of Community resources, principally to finance EC agricultural support, are seen as a major factor perpetuating the high levels of support.

The financial externalities result largely from the Community's budgetary arrangements, as agricultural support constitutes two-thirds of total expenditure. The larger a member's agricultural sector, the greater is its return on its budgetary contribution to the Community. For an individual country contributing, say, 20 per cent of the Community's marginal revenue, the cost it incurs from seeking additional marginal returns through the Community budget in the form of export restitutions or other budgetary aids is only one-fifth of its extra contributions. This gives individual countries an incentive to maintain high levels of national budgetary expenditure on agricultural research and development. By so doing, additional costs of agricultural support to the country are largely externalised by transferring them to the Community. Similarly, political costs associated with pricing decisions can be externalised for individual countries by transferring the blame for unpopular decisions to other member countries.

**Basic reasons for slowness of reform**

**Unwillingness to appreciate costs of protection**

**Indirect costs to other industries**

**Institutional factors maintaining protection**

**— financial and political externalities**

- subsidies from industrial countries
- balance between national interests
- convenience of price support
- inertia of large administrative systems
- Weak international trade rules for agriculture

Of course, for the Community as a whole, marginal expenditure on agricultural support must be matched by equal marginal contributions. Consequently, although each member has an incentive to expand agricultural production to obtain as large a return on its contribution as possible, some countries end up markedly subsidising the agricultural sectors of others. In particular, the Federal Republic of Germany and the United Kingdom, both with limited capacities to expand agricultural production and both net importers of agricultural products, have been subsidising the agricultural sectors of other members. These countries are in an ambiguous situation — they have an incentive to maintain their own agricultural production in order to limit their net contributions to the Community yet, at the same time, they have an incentive to restrain total EC agricultural production and support, thereby limiting their total budgetary contributions.

The CAP represents a very sensitive balance between the national interests of the EC member countries. Any marked change in that balance can be seen to detract from European unity. The balance between interests can be envisaged partly in terms of the interests of net contributors to the EC budget and net recipients. The net contributors have a vested interest in restraining EC agricultural support, but the net recipients have an interest in maintaining high support levels. The United Kingdom has been the main proponent of price and support restraint in agriculture. However, its influence could have been reduced by its acceptance of the 1986 increase in the Community's own resources in return for a reduction in its marginal rate of contribution to the EC budget. The Federal Republic of Germany, the main net contributor, is caught between a tradition of high support for its agricultural sector and the high cost it is paying to support the agricultural sectors of other members. To date there has been no indication of any softening in the strong German stance on agricultural protection.

The price mechanism has been convenient politically for delivering agricultural protection, as consumers are unable to gauge the extent of support, and generous price decisions can be used as a means of addressing a multiplicity of policy objectives — even if they do not address them very effectively.

A large system has been established to determine and administer the support for EC agriculture. Once established, the system is strongly self-perpetuating as it becomes regarded as indispensable to the operation of the support arrangements, which are themselves considered to be indispensable for many of the reasons already given.

### **The way forward**

The CAP imposes substantial costs on the economies of rural exporting countries like Australia, New Zealand, Canada and Argentina. These countries do not have the economic power to influence EC policies more than marginally. It would be to their advantage if there were a strengthening of the international rules concerning agricultural and trade policies in international forums, especially the General

Agreement on Tariffs and Trade. Unfortunately, many countries regard agriculture as different from other industries and the GATT rules for agriculture, especially those on subsidies, are very weak. Australia, as a generally cost-efficient producer, would gain markedly if GATT disciplines on export subsidies were strengthened. Because of the cost to the EC economy from agricultural support, it is possible that the Community itself could, in time, see the benefits of tighter rules governing subsidies.

However, given the weakness of the present GATT rules and the damage being done by the Community's and others' subsidies, alternative trade strategies need to be considered and, where appropriate, adopted. Two alternatives are bilateral arrangements and the formation of a trade group within a region. Although these alternatives may have some benefits, there are more problems. For example, small countries like Australia, which lack market power, are not in a strong position to negotiate highly favourable bilateral agreements. Furthermore, the more that countries resort to bilateral arrangements, the smaller and more volatile the world free market becomes. Also, if Australia were to expand agricultural exports through bilateral and regional economic co-operation, its partners would seek greater access for their products to the Australian market. Consequently, benefits of such trade would depend on whether previously intractable problems concerning restrictive Australian barriers to entry of manufactured products could be overcome. Nevertheless, these alternatives could pay handsome dividends, if imaginative initiatives were taken, and should be examined closely.

The economic arguments that countries like Australia should provide countersubsidies to farmers to offset the depressing effect of others' policies on prices are weak. Australia as a nation is poorer as a result of that price depressing effect. But no policy response other than convincing the European Community and others to change their policies to make them less harmful can alter that fact, although policies can alter how the burden of the loss is spread throughout the community. To determine whether compensation should be provided and whether agriculture should be singled out requires social judgments to be made. If compensatory support were provided, and depending on the form of compensation, it could significantly reduce aggregate Australian income further; additional and substantial practical problems (increased taxes or budget deficits) would be encountered.

As well as the price depressing effect of other countries' agricultural policies on the export industries of a country like Australia, there is the depressing effect of restrictive domestic import policies that effectively tax exports. In the case of Australia, it has been estimated that the protection afforded the manufacturing industry has a short-run effect that is greater than the estimated impact of the CAP. There is, however, an important difference between these two costs. The cost to the Australian economy through the world price depressing effect of the CAP is similar to the cost to the Australian rural sector. On the

**Bilateral and regional  
co-operation  
alternatives**

**Arguments for  
countersubsidies  
weak**

**World agricultural  
prices and  
Australian protection**

**Many would benefit from CAP reform**

**Two important factors**

— **recognition of full cost**

— **many costs of CAP unnecessary**

**Case for reform must be well articulated**

**Better ways to achieve objectives**

other hand, much of the cost of import protection given to other Australian industries, that is largely borne by agricultural export industries, represents a transfer to others within the Australian economy.

Countries like Australia, Canada, New Zealand and Argentina have a common interest with the European Community in reforming the CAP — all face substantial economic costs as a result of EC agricultural protection. For the former group of countries, those costs are very apparent; for the European Community, the costs have been only partially recognised — more as a budget management problem than an economic problem. However, there is unlikely to be fundamental reform of EC agricultural policies that would markedly reduce the costs both to the Community itself and other countries until there is an appreciation in the Community of two major factors.

- Costs of agricultural support in the Community are much greater than the support provided through the EC budget. They extend to adverse effects (including lower employment) in other sectors of the economy as well as direct and indirect transfers to agriculture and loss of Community income.

- Many of the economic costs associated with the CAP and the adverse effects on other countries are unnecessary and could be prevented or markedly reduced if appropriate mechanisms were employed to meet the Community's policy objectives in the most efficient ways.

It is likely that the motivations for CAP reform will come mainly from within the Community. However, the difficulties in realising reform of the CAP should not be underestimated. It is no easier to change agricultural policies in the Community than it is in other countries like the United States or Australia. Indeed, it is argued that, because of the institutional process of policy making in the Community, major changes to the CAP will be more difficult. Even if change is slow, that reform is most likely to occur if the case for it is well articulated, the costs of not making the reforms are fully recognised and policy makers are convinced of the need for change.

The first step in this process is to recognise that trade problems associated with the CAP are a by-product of pursuing policy objectives with inappropriate policy instruments — mainly open-ended price support. The second step is to identify policy objectives clearly and eliminate many of the contradictory elements evident in the current generalised statements of objectives. The third step is to match appropriate specific policy instruments to each objective and assess the benefits and costs associated with each alternative. The benefit-cost assessment should take account of all effects that can be identified — trade effects, costs to other sectors, including aggregate employment effects, as well as costs to taxpayers and consumers and to the economy. The most appropriate solutions to policy-induced problems generally lie in correcting the domestic support policies — that is, the cause of the problem — rather than in treating the symptoms. If the symptoms (for example, surplus production) are

treated by using measures to subsidise exports (for example, long-term contracts and export credits), world prices are depressed further, thereby exacerbating the problems.

This kind of approach can be, and is being, pursued by research bodies in universities and institutes, by national and international organisations and by independent authorities concerned with the development of efficient policies. However, there is relatively limited *systematic* analysis of the costs of EC industry support, including those associated with the CAP, and co-ordination of research effort and public debate beyond that concerning individual members' interests. An example of such co-ordination and debate can be found in Australia, where a statutory authority has been functioning for more than a decade, providing a basis for better informed and more open public debate on protection policies.

Within the European Community there is acknowledgment of the need for change in the Common Agricultural Policy. Although the moves following the major policy reviews in 1981 and 1983 have been tentative, there is a growing awareness of the problems caused, and continuing to be caused, by open-ended agricultural support. The Commission appreciates that there is a need for greater orientation toward a price policy in which recognition is given to the realities of the internal and external markets. Conditions in these markets are closely interrelated. Therefore, the costs and management difficulties associated with the CAP can be markedly reduced only by more closely aligning internal EC market price signals with those emanating from world markets. This means that such alignments will need to extend beyond reducing the gap between general EC price levels and prices on world markets to more closely linking variations in domestic price signals with variations in world prices.

Given the conflicting perceptions of policy objectives by different EC countries, there is a risk that future changes might even exacerbate many of the costs and inefficiencies associated with the CAP. For example, 'reform' could consist of transferring support costs from taxpayers to consumers to overcome budgetary management problems, and extra measures could be introduced to assist exports and limit imports. Those 'reforms' could result in substantial additional costs to the Community and to many other countries, both developed and developing. Improved articulation of policies and mechanisms that would achieve the Community's policy objectives more effectively and at lower cost would help to prevent such an outcome. This, in time, should result in substantial benefits to the Community and others. Such an approach will require the development and acceptance of the need for price policies, both internal and external, that are more closely attuned to realistic market opportunities.

**Desirability of an independent body to appraise policies**

**Recognition of need for change exists**

**Need for price policies to reflect realistic market opportunities**